COMPENSATION PEER GROUP: GETTING IT RIGHT!

By Chris Crawford, Cameron Boswell and Kyle Lamport

Choosing the right executive compensation peer company has become a hotly debated issue in the board room. Companies use peer groups to assess and maintain competitive compensation levels, identify potential competitors, assess relative performance and defend compensation decisions. In short, getting the right compensation peer group right at the beginning is absolutely key. Or, in other words, creating the wrong peer group not only creates the perception of a lack of governance in the compensation setting process, but it also often results in compensation that is too high or not closely competitive. In this case, digging a company out of that mess can become very complicated.

Where many companies miss the boat in the peer selection process, and understandably so, is the assumption that all competitors should be peers and all peers should be competitors. This is a mistake as it relates to executive compensation. These two groups are usually distinct from one another. A competitor is not necessarily a peer company and vice versa. A potential competitor is a company that operates in the same general space, with similar size operations, commonly measured by revenue, assets, employees, and market capitalization, and it may or may not include some direct competitors. While competitors definitely should be considered for the peer group, many other factors should be considered for executive compensation: peer company selection. Although this list is not exhaustive, the following five factors are considered the most important ones to consider.

Size.

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The key here is where can you draw talent from and where do you lose talent to, industry-wise.

Performance.

Reviewing a potential peer company’s historical performance relative to your company provides good insight into the decision to include it. Consistent under-performers may not likely be ideal peers for many companies, including: (1) peers that are much smaller, and (2) if performance is measured relative to the market, and performance is measured relative to the market. You should attempt to identify the best strong performers, within the industry, and compare to those. Doing so will help better identify a more realistic peer group and potentially inspire companies to increase performance to the level of their peers. Lastly, strong performers typically have much more efficient total rewards programs that are crisply articulated and effective.

Geography.

A consideration that often arises is the geography of the company. While the geography of peer companies should be a consideration, it shouldn’t be a key driver in determining the peer group. Specifically, if a company was looking to replace the CEO or CFO, it would not limit its search to the city where it’s located. This logic would hold true if searching for a staff accountant, making geography much more important below the executive level. Therefore, when determining a peer company for executive compensation purposes, geography becomes less important. One other point to consider relating to geography is national versus international peers. Companies headquartered in the U.S. have international assets or are traded on an international exchange. However, utilizing international peer companies for executive compensation comparisons typically does not yield good comparisons since international executive compensation is structured so differently than the U.S.

Final Observations.

All of these factors are important considerations when developing a peer group to determine competitive executive pay. This list is not all-inclusive, and other factors such as operational footprint, business complexity, operating margins and more should be key components for peer group selection. Additionally, factors such as compensation comparators below the executive level are very different. Often, competitors and geography are the major drivers for developing market competitive compensation.

Finally, the process used to analyze each of these factors and develop an executive compensation peer group is vital to the perceived validity and integrity of the final peer group. Companies should consider the use of independent outside advisors to initiate the peer group selection process. The job of management and the compensation committee is to review, provide insight and ultimately approve the final peer group. All in all, an independent process is critical when choosing a peer group.